



August 21, 2012

BY ELECTRONIC SUBMISSION

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219

Robert Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

RE: Proposed Guidance on Leveraged Lending
(Docket Nos. OCC-2011-0028 & OP-1439)

Ladies and Gentlemen,

The Loan Syndications and Trading Association (“*LSTA*”)¹ and the American Bankers Association (“*ABA*”)² thought it would be helpful to expand upon the discussion of the “fallen angel” issue set forth in our comment letter dated June 8, 2012, concerning the Proposed Guidance published in the *Federal Register* on March 30, 2012 by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit

¹ The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The 321 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

² The ABA represents banks of all sizes and charters and is the voice for the nation’s \$14 trillion banking industry and its 2 million employees. Additional information about the ABA is available at the ABA’s website, www.aba.com.

Insurance Corporation (collectively, the “*Agencies*”).³ We seek to further clarify our position regarding the definition of “leveraged finance.” As we previously stated, the Proposed Guidance should not encourage or require that the term “leveraged finance” be applied to “fallen angels” and other loans not designated as leveraged at the time of origination. Such definition should include only those loans that contain the unique structural characteristics of leveraged loans at their inception, and should not sweep up loans made to borrowers that over time diminish in credit quality.

I. If the definition of “leveraged finance” is not limited to loans that are identified as leveraged at their inception, monitoring leveraged loans will become more difficult, as will setting limits and determining loan origination criteria.

Inclusion of “fallen angels” in a bank’s leveraged loan portfolio will not enhance a bank’s or its examiners’ ability to ascertain the risk of the portfolio. Rather, putting “fallen angels” into the leveraged loan category is likely to impair the ability to make risk assessments on outstanding loans and will also make future loan origination more difficult and potentially more risky.

The arbitrary inclusion in the leveraged loan portfolio of loans that do not share the representative characteristics of loans originated as leveraged will add “static” to the data that banks collect on leveraged loans. This contamination of the data pool will make it difficult for banks to assess the actual performance of loans that were originated as leveraged loans. A bank’s leveraged loan portfolio will expand and contract over time, as loans fall into and out of the reporting category due to fluctuations in credit quality.

According to Moody’s Investors Service, the 1920-2011 average one-year corporate migration rate from Baa to non-investment grade was 6.12%. Similarly, as an example, a bank representative of those we have spoken with reviewed its entire portfolio over a recent two-year period and determined that 31% of its portfolio was rated non-investment grade at inception. Two years later, 42% of the portfolio was rated non-investment grade (or unrated/ had exited). In the BBB/BBB- category, 28% of the borrowers migrated to non-investment grade (or unrated/had exited). Conversely, 22% of the issuers rated the equivalent of BB/BB+ at the beginning of the period were rated investment grade two years later. While these examples relate specifically to movement in and out of investment grade, they illustrate that there can be material ratings migration within a portfolio.

With loans entering and exiting the leveraged loan portfolio, cohort analysis of the portfolio will be functionally impossible, given the constantly changing set of loans to be

³ Proposed Guidance on Leveraged Lending, 77 Fed. Reg. 19,417 (proposed Mar. 30, 2012).

included in the pool.⁴ On the other hand, the traditional approach of categorizing loans only at inception appropriately isolates and identifies a specific type of lending activity and its risks.

The inclusion in the leveraged loan portfolio of a borrower whose financial performance and prospects have deteriorated and which now meets all the criteria for a leveraged loan will further distort the leveraged loan pool data due to the inclusion of borrowers that have relatively short-term performance issues which are not reflective of overall credit quality, such as borrowers that have suffered an unusual write-down or loss, are in a cyclical business or have been subject to unforeseen short term disruptions.⁵ The Proposed Guidance would, however, require that such a loan be included in a bank's leveraged loan portfolio, at least until such borrower's financial results improve. The fundamentally inaccurate data generated will in turn impair the ability of banks to set credit policy and limits going forward, as well as the ability to properly stress test new loans.

Because of the uncertainty of the universe of loans to be included in the leveraged loan category and the inability to predict which borrowers may become "fallen angels", risk managers might well be forced to raise aggregate credit limits for their leveraged loan portfolio, in order to account for both leveraged loans at inception and for a future – but unknowable – number of "fallen angels" that have migrated into the leveraged loan category. In addition, including "fallen angels" in the leveraged loan portfolio will likely skew the average performance of the portfolio as a whole (in light of the fact that "fallen angels" might well have lower leverage ratios than most leveraged loans), giving the appearance of overall better performance of the leveraged loan portfolio. Although it is difficult to predict what unintended consequences may result from putting "fallen angels" into the leveraged loan portfolio, the artificially high credit limits and skewed performance assessments may result in increased appetites for credit risk, with banks utilizing increased credit limits to originate more leveraged loans. Alternatively, if banks do not adequately allow room in the limits for "fallen angels", the opposite effect could result, with banks providing less liquidity to credit-worthy leveraged loan borrowers.

Clearly if the foregoing occurs it will weaken, rather than enhance, the management of leveraged finance risk and will have the consequence of undermining the utility of the proposed requirements for information collection and reporting.

⁴ Cohort analysis depends on a defined set of study participants. Consider a long-term medical study of smokers. If individuals who are non-smokers at the start of the study but later take up smoking are added to the pool of subjects during the course of the study, the data collected during the study will not likely be helpful to any large degree.

⁵ For example, Teck, a Canadian diversified mining company, was rated investment grade in mid-2008 when it acquired Fording Canadian Coal in all all-debt deal. After the acquisition, Teck's ratings were downgraded in late 2008-2009 due to poor conditions in the company's core markets. Teck regained its investment grade ratings at the beginning of 2010, following the company's deleveraging post-acquisition and improving industry fundamentals. However, adding Teck's debt to the bank's leveraged loan portfolio and then removing it following the company's recovery would have distorted reporting of the leveraged loan portfolio.

II. Banks already monitor loans not designated as leveraged at the time of origination for problem risk assets and risk migration.

To the extent the proposed expansion of “leveraged finance” criteria to include “fallen angels” is due to a concern that non-leveraged loans are not properly monitored, we believe that this concern is adequately addressed through each bank’s existing credit standards and risk monitoring. Loans not designated as leveraged at the time of origination are monitored for problem risk assets and risk migration according to bank policies and procedures (including via, among other things, summary risk ratings, risk migration reporting, asset quality forecasting and stress testing). Troubled non-leveraged loans are reported to the OCC not only on a continual basis but also in response to the Agencies’ information requests.

The LSTA and ABA believe that the monitoring policies and procedures for non-leveraged loans have worked well to ensure appropriate oversight of such loans. Having these loans transition from standard monitoring to leveraged loan monitoring is more likely to complicate and confuse than assist lenders in the management of their loans.

III. Banks will incur extensive costs to generate the information required by an expanded definition of “leveraged finance,” without any benefit to the banks or examiners.

In order to comply with the “fallen angel” provisions outlined in the Proposed Guidance, banks will need to incur extensive costs and devote considerable resources. Management information systems (“*MIS*”) would have to be significantly overhauled to include an additional tracking and reporting process to monitor loans that could potentially become leveraged loans. The Proposed Guidance would require tracking of essentially every loan related in whole or in part to an acquisition or distribution, in case the borrower’s debt to EBITDA ratio exceeds set thresholds in the future. Doing so would necessitate that banks recode their MIS, a process that is both difficult and costly, requiring a massive number of hours of work at each bank. Additionally, the complexity of the analysis will result in a slower, more expensive process that will not provide the “real time” analysis the Proposed Guidance is intended to promote and may be more prone to error. As discussed above, not only will no benefit result from this change in reporting, but the change could result in skewed data and potentially more risky behavior on the part of banks.

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For the foregoing reasons, the LSTA and ABA respectfully request that the Agencies revise the scope of the Proposed Guidance to exclude from the definition of “leveraged finance” those credits that were not designated as leveraged at the time of origination. The use of such an expansive definition will diminish the quality of information and management of the leveraged loan portfolio, which may serve to undermine the utility of the proposed collection and reporting of information. In addition, the proposed change in the definition could have unintended consequences with respect to the amount of new leveraged loans originated.

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We sincerely appreciate your consideration of our comments and stand ready to provide any additional information you believe might be useful. If you have any questions, please do not hesitate to contact: Elliot Ganz, General Counsel, LSTA (eganz@lsta.org; (212) 880-3003); Meredith Coffey, Executive Vice President for Research and Analysis, LSTA (mcoffey@lsta.org; (212) 880-3019); Denyette DePierro, Senior Counsel, Office of Regulatory Policy, ABA (ddepier@aba.com; (202) 663 5333); or Robert Strand, Senior Economist, Office of the Chief Economist, ABA (Rstrand@aba.com; (202) 663-5350).

Sincerely,

THE LOAN SYNDICATIONS AND
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